

Reader Raises Like-Kind Exchange Questions

This column provides an informal exchange of ideas, questions, and comments arising in everyday tax practice. Readers are invited to write to the editors: Richard M. Lipton, Senior Counsel, Baker McKenzie, Dallas, Texas, richard.lipton@bakermckenzie.com; Daniel Cullen, Partner, Baker McKenzie, Chicago, Illinois, Daniel.Cullen@bakermckenzie.com; and Leah Gruen, Counsel, Baker McKenzie, Chicago, Illinois, leah.gruen@bakermckenzie.com.

Two of your editors recently co-authored a piece in *The Journal* concerning "The State of the Art of Like Kind Exchanges;" this was the eighth iteration of this piece, which started back in 1999. We received a response from Roger Upton, a CPA in New York, who asked the questions set forth below. Roger teaches CPAs on real estate-related issues, and he asked some good follow-up questions which your co-editors believe are a good starting place for a discussion in Shop Talk.

Here are Roger's two questions and some thoughts from your co-editors:

The State and Local Law exception – what "law" is supposed to be applied? For example, in NY, we have State income tax, sales tax, real estate tax (but no personal property tax) – are you required to look into all three categories? The Regs do not seem to specify what law. Another example, when I teach I use the example of a kitchen cabinet. If you ever renovated a kitchen as a DIY project, you know cabinets can be pretty easy to remove – even a CPA can do it without causing much damage, and in some circumstances, the cabinet can either be donated or sold. So is it real property for 1031 purposes? In Minnesota, under the State's income tax law definition, I believe the cabinet is not real estate. However, if you look up the State's sales tax law, it specifically says a kitchen cabinet is real property. Personally, I liked the post 2012 Federal law rule, because I think knowing the definition under different States and localities, and maybe needing to look into different law categories, is an unreasonable burden for many taxpayers. (Another example, for Arizona, we had to go to a particular Court case to get the definition of what real property was) So back to my question – does a taxpayer have to look into all different types of a particular State's law to see what the definitions are?

Roger's question refers to the provision in the now-finalized regulations under Section 1031 which provide a definition of real property. As discussed in an article in *The Journal* from one of your editors and

Lou Weller,¹ the final regulations provide that assets which are considered to be "real property" for state law purposes are treated as real property for purposes of a Section 1031 exchange. However, the final regulations do not indicate how state law should be defined for this purpose, including which state law is applicable. Moreover, because different states have different types of taxes, it is not even clear whether a state tax law (real property tax?) or some non-tax law should be considered for this purpose. Other possibilities include each state's real property "common law" (for all states other than Louisiana) as well as the commercial laws that apply in each state. The bottom line is that the regulations under Section 1031 simply do not answer this question. However, as stated in the preamble to the final regulations, Congressional intent is for "'real property eligible for like-kind exchange treatment' under the law in effect prior to enactment of the TCJA to continue to be eligible for like-kind exchange treatment after enactment of the TCJA."² So, this conundrum of applying state and local law is not new.

Your editors have always viewed this rule in the final regulations under Section 1031 as taxpayer-favorable because it allows taxpayers to consider a variety of alternatives in order to classify property as "real property" for purposes of Section 1031. Since the scope of like-kind exchanges was limited to real property by Congress in the TCJA, many taxpayers were hoping that the definition of real property would not be artificially limited by the IRS or the courts, and the final regulations provided some very helpful guidance in this regard.

Moreover, it is not always clear whether or not a taxpayer would want a broad definition of "real property" for purposes of Section 1031. For example, assume that two taxpayers located in different

states have engaged in a two-party direct exchange (no qualified intermediary), and one taxpayer has a property with a built-in gain while the other taxpayer has a tax loss inherent in the relinquished property. The taxpayer with the loss property would prefer that the exchange not qualify for purposes of Section 1031 while the taxpayer with the gain property might prefer a like-kind exchange in order to defer gain in the relinquished property. So you have one taxpayer that wants to treat an asset as real property, and the other does not. Which law applies – the state law where each property is located, the state law where each taxpayer lives, or some other state law that the parties have agreed should govern the transaction? And could there be a different result for each of the parties, even though this was a two-party direct exchange?

So the answer to Roger's first question is: we don't know for sure, either. We would be happy to get input from our readers.

Like kind definition when it is applied to Sec. 1245 property. I have seen articles that say any Sec. 1245 property (that meets the Sec. 1031 definition of real property) can be exchanged for other Sec. 1245 property (that meets the Sec. 1031 definition). I have also seen other articles that say that Sec. 1245 property has to be similar, and then what does that mean? For example, I am exchanging an apartment building for a medical building in NY. NY law has an easy to follow definition of real property – basically anything that is typically sold during a real estate sale is real property. So does my apartment's 1245 property of things like kitchen cabinets and carpeting qualify under the exchange rules for Sec. 1245 property in the medical building? For depreciation purposes, they have the same Asset Class (57.0). Does your answer change if I am exchanging nut trees (which are Sec. 1245 property and also considered Real Property in most States) for an apartment building? Definitely not "apples to apples." But both 1245 assets.

Your editors had always thought that any 1245 property could be exchanged for any other 1245 property, provided that both were treated as real property for purposes of Section 1031. However, Roger is concerned that there might be an argument to the contrary. So your editors contacted Lou Weller of Weller Partners LLP, who advised as follows:

"The regulations are quite clear. First, classification for depreciation purposes under Section 168 does not determine whether or not property is real estate for purposes of Section 1031. Second, the key issue is whether the property is within the definition of real estate in the final regulations.

If it is a permanent interest in real estate, then it's like kind to any other real estate, including a fee interest, an interest in a transferable development right or a fixture that is real estate under state law. The asset class for MACRS purposes doesn't matter for purposes of Section 1031. However, the recapture rules are different: recapture is avoided only if MACRS property is exchanged for other MACRS property. It does not appear that you have to match 5 year to 5 year, 7 year for 7 year or 15 year for 15 year, but a taxpayer cannot avoid recapture by exchanging 15 year MACRS property for either 27.5 year or 39 year real property. The nut tree is a good example. Gain might be deferred under Section 1031,

but Section 1245 recapture will apply in full because the apartment building is not Section 1245 property, so Section 1245(b)(4)(B) would require recapture."

As always, we value our readers' comments and thoughts.

End Notes

¹ L. Weller, R. Lipton, J. Christianson and M. Carlson, "Final Regs Defining 'Real Property' for Section 1031: IRS Gets It Right With 'State Law Plus,'" 134 JTAX 10 (February 2021).

² TD 9935 (*citing* H.R. Conf. Rept. 115-466, at 396, fn. 726 (2017)).

